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MUNICIPAL AUTHONOMY IN FEDERALIST STATES

1. INTRODUCTION

In most countries, the political and administrative power is not only concentrated on the national level but is distributed among national, regional and local authorities. At the same time, the extent to which the regional and local authorities can act autonomously differs substantially. While France and Japan are said to be the most centralist countries in the developed world, Germany, Switzerland, the US and Canada are characterised by a substantial degree of autonomy on the regional and local level¹.

Until the 1980s, the socialist countries in Central and Eastern Europe were strongly centralist. Until today, some of them have gone through a process of decentralization in which substantial power has been transferred to regional and municipal administrative bodies. This process was, however, not primarily driven by the normative theory of fiscal federalism². Instead, it very often was the result of separatist movements on the regional level coinciding with a vacuum of power on the national level. Especially the decline of the former Soviet Union has given rise to powerful regional leaders who claim more

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¹ Prud'homme, R. France, *Central-Government Control over Public Investment Expenditures*, [in:] W. E. Oates (ed.), *The Political Economy of Fiscal Federalism*, Heath and Company Lexington-Toronto D.C. 1997, p. 65-73; B. Seidel, D. Vesper, *Fiscal Federalism – an International Comparison*, „Vierteljahreshefte zur Wirtschaftsforschung“ 1999, 68 (3), p. 449-472.

² R. M. Bird, R. D. Ebel, C. I. Wallich, *Fiscal Decentralization: From Command to Market*, [in:] R. M. Bird, R. D. Ebel, C. I. Wallich (eds.), *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, The World Bank, Washington D.C. 1995, p. 1-67 and references; Reprinted in: W. E. Oates (ed.), *The Economics of Fiscal Federalism and Local Finance*, Edward Elgar Publishing, Cheltenham-Northampton 1998, p. 646-717.

power for their regional authorities³. In general, the countries in transition missed the chance to install an efficient federalist structure in the process of transition.

The task of installing an efficient federalist structure is a complex process and requires a number of different questions to be addressed. Some of them are: How much levels of government should the new federalist structure have? If more than one, which level should be responsible for which tasks and revenues? How should the fiscal relations between the different administrative bodies be organized? What size should the administrative bodies, especially the municipalities have to be able to provide public goods and services at minimum costs? How should the administrative bodies organize their internal administrative processes in order to be able to fulfil their tasks efficiently? To what extent and in which fields should the municipalities be granted autonomy in tasks and revenues? The list of questions could be extended substantially.

This paper picks out the last question and delivers a short outline of the scientific debate on this issue. The analysis starts by defining municipal autonomy and illustrating its dimensions. Based on the normative theory of fiscal federalism as well as on the economic theory of constitution, section 3 discusses the major pros and cons of far reaching municipal autonomy. In section 4 key tasks of the central administrative body in a federalist state with far-reaching municipal autonomy are described.

2. DEFINITION AND DIMENSIONS OF MUNICIPAL AUTONOMY

Municipal autonomy consists of two basic elements. First, autonomy in tasks is given if the municipality can define its own tasks and decide about the extent to which it follows these tasks. Second, autonomy in revenues is given if the municipality can raise its own funds. Even when comparing the federalist countries like Germany, Switzerland, the US or Canada, substantial differences in the degree of municipal autonomy in tasks and revenues can be observed⁴. In reality, different types of tasks and revenues can be differentiated, depending on the degree of municipal autonomy. The passages below gives an overview over these different types of tasks (section 2.1) and revenues (section 2.2) in German municipalities.

³ C. Mick, *Probleme des Föderalismus in Rußland*, „Osteuropa“ 1994, 44 (7), p. 611–629; I. M. Busygina, *Der asymmetrische Föderalismus: zur besonderen Rolle der Republiken in der Russischen Föderation*, „Osteuropa“ 1998, 48 (3), p. 239–252.

⁴ B. Seidel, D. Vesper, *Fiscal Federalism – an International Comparison*, „Vierteljahreshefte zur Wirtschaftsforschung“ 1999, 68 (3), p. 449–472.

2.1. Autonomy in tasks

For a number of tasks, the municipalities are totally free in their decision about whether, how and to what extent to fulfil them⁵. These are called tasks of voluntary self-government. In the German Bundesland of Hessen, building and running public theatres and opera houses, public local libraries and swimming baths represent examples for this type of tasks. In addition, the municipalities can decide about measures to spur the local economy e.g. by providing special local infrastructure⁶.

In the so-called tasks of obligatory self-government, the municipalities are less autonomous. They are forced to fulfil the corresponding tasks and can only decide freely about how to follow this obligation⁷. In Germany, the provision of public assistance belongs to this category. The central government sets a minimum standard concerning the level of public assistance and the group of recipients. Each municipality has to provide public assistance which satisfies these standards but is free to grant additional payments. In addition, it can decide about how to organize the process of providing public assistance. This includes the possibility to account for differences in the local costs of living. In Hessen, the obligatory self-government furthermore includes local road construction, waste disposal and the provision of cemeteries⁸.

Third, municipalities carry out some tasks only on behalf of regional or national governments. In these cases, the municipalities can neither choose whether or not nor to what extent they fulfil the task. Formally, they are free to decide about procedural matters, but this does not leave much space for truly autonomous decisions in reality⁹. Among other things, the municipalities in Germany run the residents' registration office, supervise local building and construction activities on behalf of superior administrative bodies. In addition, the municipalities have to control and enforce national and regional environmental and water quality standards on the local level¹⁰.

2.2 Autonomy in revenues

Apart from autonomy in tasks, the municipalities also have some degree of autonomy in revenues. The degree of municipal autonomy is high for

⁵ K. Stern, I. Gemeinden, *Rechtsstellung in der Bundesrepublik Deutschland*, [in:] W. Albers et al. (eds.), *Handwörterbuch der Wirtschaftswissenschaft 3*, Stuttgart-New York 1980, Gustav Fischer Verlag, p. 486-495.

⁶ D. Birkenfeld-Pfeiffer, *Kommunalrecht*, Nomos, Baden-Baden 1998, p. 104.

⁷ K. Stern, *op. cit.*, p. 491.

⁸ D. Birkenfeld-Pfeiffer, *op. cit.*, p. 104.

⁹ K. Stern, *op. cit.*, p. 491.

¹⁰ D. Birkenfeld-Pfeiffer, *op. cit.*, p. 104.

those revenues which the municipalities earn in exchange for offering goods and services to local firms and the local population. Public charges belong to this category of revenues. In 1996, these accounted for 14,6% of the local budget in Germany. Another 2,1% respectively 4,9% stemmed from selling concessions and from market income, e.g. from local publicly owned enterprises¹¹. These revenues are also largely controlled by the municipal authorities. Though no permanent source of revenues, privatisation provides revenues for which the degree of municipal autonomy is large. In 1996, 4,4% of the municipal revenues stemmed from privatisation¹².

Just like in most countries, the public sector in Germany heavily relies on taxes to finance its expenditures. This is also true in the case of municipalities. In the use of so-called local taxes (e.g. dog tax or beverage tax) the municipal authorities are largely autonomous. They can define the tax base and set the tax rate. But their contribution to total revenues is small. In Germany, local taxes accounted for only 0,5% of the total municipal revenues in 1996. Some 20% of the municipal revenues in 1996 stemmed from trade tax and real property tax. Here, the tax base is determined by the national government, but the local authorities have the right to fix the so-called municipal tax factor (*Hebesatz*). In addition, the municipalities receive a fixed share of the national revenues from income tax and turnover tax, accounting for 13% of the total municipalities' revenues in 1996. Tax base and tax rate are fixed on the national level, leaving the municipality no autonomy in revenues.

Public debts are another source of municipal revenues. In Germany, municipalities are very restricted in their use of this instrument. Despite these strict rules, German municipalities, especially large cities, have piled up substantial public debts. In 1998, the per capita debt of Frankfurt am Main amounted to 8532 DM and doubled the corresponding figure for Giessen (4192 DM). On average, the public debts per capita in cities rises with the number of inhabitants. At the same time, some large cities – e.g. Munich (3507 DM) and Stuttgart (2451 DM) – managed to keep public debts under control quite well¹³. In 1996, the municipalities received 2,7% of their revenues from additional debts¹⁴.

Finally, municipalities receive direct grants, mostly from superior administrative bodies within the federalist state. Just like in most countries, German municipalities get conditional (*Schlüsselzuweisungen*) and unconditional

¹¹ H. Zimmermann, *Kommunalfinanzen: Eine Einführung in die finanzwissenschaftliche Analyse der kommunalen Finanzwirtschaft*, „Nomos“ 1999, Baden-Baden, p. 129.

¹² *Ibidem*, p. 129.

¹³ G. Glaser, *Schuldenstand 1998*, „Statistisches Jahrbuch Deutscher Gemeinden“ 1999, 86, p. 499–502.

¹⁴ *Ibidem*, p. 129.

grants (*zweckgebundene Zuweisungen*). The amount of unconditional grants a municipality receives depends on its number of inhabitants and some socio-economic indicators. Unconditional grants account for 32,8% of the municipal revenues in Germany in 1996¹⁵. The local authorities do not have any influence on the amount of grants they receive. This is different for the conditional grants. These are granted only to support the municipality in covering expenditures in certain pre-defined fields. In most cases, these grants take the form of subsidies for infrastructure projects. The municipality can thus increase the amount of conditional grants by investing in the pre-defined fields. This restricts the autonomy in tasks, because the granting administrative body decides about the way in which the granted financial means are used¹⁶. On the other hand, it leaves some autonomy in revenues to the municipal authorities. In 1996, conditional grants accounted for 7,1% of all municipal revenues¹⁷.

2.3 The relationship between autonomy in tasks and autonomy in revenues

Section 2.1 and 2.2 showed that the municipalities are limited in their autonomy in tasks as well as their autonomy in revenues. Many tasks and revenues are determined on the regional or national level. Especially larger cities complain about the fact that the externally determined revenues are insufficient to cover the costs of fulfilling the externally determined tasks. In particular the increasing public assistance payments are not covered by higher vertical transfers. In 1994, the German Bundestag passed a law according to which the municipalities are obliged to provide a place in kindergarten for every child, but the additional costs the municipalities had to incur following this law were not covered by additional vertical grants. This and similar political decisions by the central government substantially reduced the effective municipal autonomy by reducing the disposable financial means to fulfil their voluntary self-governing tasks¹⁸. Therefore the advocates of municipal autonomy demanded that the regional and national governments should only be allowed to transfer tasks to the local

¹⁵ *Ibidem*, p. 129.

¹⁶ E.g. W. E. Oates, *Fiscal Federalism*, Harcourt Brace Jovanovich, New York-Chicago 1972, p. 65-94.

¹⁷ H. Zimmermann, *op. cit.*, p. 129.

¹⁸ E.g. K. Hofmann, W. Scherf, *Die Auswirkungen der Steuerreform 2000 auf die Gemeinden*, „Finanzwissenschaftliche Arbeitspapiere“ 2001, Nr. 60.

authorities if the necessary financial means to cover the corresponding expenditures are provided simultaneously. In Germany, these calls have so far not been implemented.

3. ADVANTAGES AND DISADVANTAGES OF FAR-REACHING MUNICIPAL AUTONOMY

Following the short introduction to the dimensions of municipal autonomy in section 2, this section approaches municipal autonomy from the normative point of view. It reviews the pros and cons of far-reaching municipal autonomy in comparison to a (more) centralist structure of the state. Section 3.1 provides points in favor of far-reaching municipal autonomy while 3.2 stresses the disadvantages of municipal autonomy. In both sections, two different courses of argumentation are provided. Emphasizing the situation of a single municipality the first course of argumentation analyses whether the municipal or a larger administrative body can best guarantee an efficient provision of public goods and services. The second course of argumentation is based on the model of Tiebout (1956)¹⁹. He pointed out that administrative bodies of the same level enter a process of competition for scarce resources and residents which changes the incentives and the scope of the municipal authorities.

3.1. Advantages of far-reaching municipal autonomy

3.1.1. Demand orientation of publicly provided goods and services

An efficient supply of public goods and services demands – among other things – that the supplied bundle of public goods and services fits the preferences of the local consumers²⁰. Therefore municipalities whose inhabitants differ in their preferences have to provide different bundles of public goods and services. Regional and especially national authorities will normally find it very difficult to account for local differences in preferences. Instead, they will provide a uniform bundle for all municipalities. This bundle may fit the preferences of the average municipality (which in reality does not exist)

¹⁹ For a formal presentation of the Tiebout-model, see e.g. P. Pestieau, *The Optimality Limits of the Tiebout Model*, [in:] W. E. Oates (ed.), *The Political Economy of Fiscal Federalism*, D. C. Heath and Company, Lexington-Toronto 1977, p. 173–186.

²⁰ E.g. A. Bohnet, *Effizienz und Preise – Zwei zentrale Kategorien in der Wirtschaftsordnungstheorie*, [in:] A. Bohnet (ed.), *Preise im Sozialismus – Kontinuität im Wandel*, Teil II: zur Theorie und Praxis gesamtwirtschaftlicher Preissysteme, Berlin 1984, p. 137–140.

but it is insensitive to local differences in tastes. Local authorities on the other hand can take into account the preferences of their particular population. Thus municipal autonomy in public good provision is a precondition for demand-orientation on the municipal level²¹.

Due to the large number of municipalities, the residents within one country can choose between numerous different good-tax-combinations. Inhabitants who are not satisfied with their local good-tax-combination can vote by feet, that is migrate to another municipality²². This process of migration causes the preferences within the municipalities to become more homogenous. At the same time, differences in preferences and thus good-tax-combinations between different municipalities grow²³. Hence the competition between municipalities increases the demand-orientation of public good provision²⁴.

3.1.2. Lower administrative costs

Local authorities can collect information necessary for planning and administrating the supply of public goods and services more easily than regional or national authorities. This is partly due to the fact, that the local politicians and bureaucrats are physically closer to the consumers. Many local politicians and bureaucrats furthermore grew up in the same region they now work in and therefore have special knowledge concerning the preferences of the local population²⁵. Due to the smaller size of the municipal administration, the administrative processes on the local level involve less hierarchy levels and are less bureaucratic. Hence municipal authorities can plan and administer the provision of local public goods and services at lower administrative costs. In addition, the local population can control the municipal administration at much less costs than the regional or national authorities. This reduces X-inefficiencies and thereby further reduces the costs of planning and administration on the municipal level.

If the local authorities do not produce the local public goods at minimum costs, they will have to impose higher taxes on their residents

²¹ E.g. W. E. Oates, *An Essay on Fiscal Federalism*, „Journal of Economic Literature” 1999, 37, p. 1123–1124; B. S. Frey, R. Eichenberger, *The new democratic federalism for Europe: functional, overlapping, and competing jurisdictions*, Edward Elgar Publishing, Cheltenham–Northampton 1999, p. 15.

²² Ch. M. Tiebout, *A Pure Theory of Local Expenditures*, „Journal of Political Economy” 1956, 64, p. 416–424.

²³ D. C. Mueller, *Centralism, Federalism, and the Nature of Individual Preferences*, „Constitutional Political Economy” 2001, 12, p. 161–172.

²⁴ E.g. W. E. Oates, *Fiscal Federalism*...p. 11–12.

²⁵ E.g. R. Schwager, *The Theory of Administrative Federalism: an Alternative to Fiscal Centralization and Decentralization*, „Public Finance Review” 1999, 27 (3), p. 283.

than a comparable municipality which works efficiently. In this case, the residents have two options to improve their own position. They can either voice their discontent by voting for another party in the next local elections. Alternatively, they can exit, that is migrate to another municipality²⁶. Both voice and exit result in a loss in power and revenues for the current local government. In order to stay in power and prevent the negative consequences of emigration, the current government faces high incentives to ensure that the public administration works at the lowest possible costs. These incentives do not exist if taxes and public expenditures are decided upon by the authorities of a higher administrative body. By inducing a competition for low taxes between municipalities, municipal autonomy fosters an efficient use of public resources²⁷.

3.1.3. More innovations in the public sector

Finally, the competition between municipalities exerts a pressure on every single municipality to develop and apply new, cost-saving administrative techniques. In this competition for innovations, a large number of different administrative techniques are applied and thereby tested simultaneously. The fact that each new technique is initially only tested in a small number of municipalities contains the potential damage of new but inefficient techniques. Once a technique proved to be superior, the competition between municipalities guarantees that this innovation is spread across the country very quickly. A (more) centralized system would not apply and test a comparable variety of techniques. In addition, local authorities would face only limited incentives to adopt superior techniques. Thus competition between municipalities induced by municipal autonomy accelerates the process of innovation in the public sector²⁸.

3.2. Disadvantages of far-reaching municipal autonomy

3.2.1. Higher costs of collective decision making

A country in which all major political decisions are made on the regional or national level does not need parliaments or elections on the

²⁶ E.g. A. O. Hirschman, *Exit, Voice and Loyalty*, Harvard University Press, Cambridge (Mass.) 1970; B. S. Frey, R. Eichenberger, *op. cit.*, p. 6.

²⁷ E.g. H. Siebert, M. Koop, *Institutional Competition: A Concept for Europe?*, „Aussenwirtschaft“ 1990, 45, p. 439–462.

²⁸ E.g. W. E. Oates, *Fiscal Federalism...*, p. 12–13; M. Vihanto, *Competition Between Local Governments as a Discovery Process*, „Journal of Institutional and Theoretical Economics“ 1992, 148, p. 415–420.

municipal level. If, however, municipal authorities are allowed to make autonomous decisions about the provision of local public goods and services, they must be legitimised by the corresponding population. Therefore municipal autonomy requires parliaments and elections on the municipal level. As both mechanisms of collective decision making cause substantial costs, countries with far-reaching decentralization have to incur more costs of collective decision making²⁹.

3.2.2. Economies of scale in the process of administration

Due to technical reasons, a number of public services cannot be provided in quantities less than a certain minimum. Other services can in principle be produced in small quantities, but only at high average costs. If the cost-minimal quantity exceeds the demand of a single municipality, a solution in which each municipality supplies these services independently is inefficient. In some cases, the administrative processes are subject to economies of scale. This is especially true for the process of collecting and administering taxes³⁰. As the number of administrative acts performed by an administrative body is a positive function of its size, the smaller municipalities cannot exploit the economies of scale to the same extent than e.g. the much larger regional authority could³¹. Hence they have to incur higher average costs of providing those public goods and services which are characterized by economies of scale.

3.2.3. Spill-overs between municipalities

For some goods and services, the beneficiaries and/or those who incur costs are not restricted to the inhabitants of one municipality. The benefits and/or costs that spill over the border of the municipality are called positive respectively negative spill-overs. In the case of positive spill-overs, decentralization is expected to lead to an inefficiently low supply of the corresponding public service. In case of negative spill-overs, the supply can be expected to be too high. In a more centralized state, the amount of spill-overs becomes smaller due to the bigger size of the administrative body

²⁹ E.g. K. Bulugtöglu, *Fiscal Decentralization: A Survey of Normative und Positive Contributions*, „Finanzarchiv” 1977, 35, p. 6–7.

³⁰ E.g. R. Boadway, *Inter-Governmental Fiscal Relations: The Facilitator of Fiscal Decentralization*, „Constitutional Political Economy” 2001, 12, p. 111–112.

³¹ E.g. K. Bulutöglu, *op. cit.*, p. 8–10; D. L. Rubinfeld, *The Economics of the Local Public Sector*, [in:] A. J. Auerbach, M. Feldstein (eds.), *Handbook of Public Economics*, North Holland, Amsterdam 1987, p. 585.

in charge³². The economic literature has identified especially two different policy fields in which spill-overs are large.

First, the policy of economic stabilization is typically characterised by very large positive spill-overs, which result from the openness of the municipal economies. A large share of locally produced goods is consumed outside the municipality. At the same time, the local population consumes many goods that are not produced locally. If a single municipality increases its expenditures in order to fight a recession, it has to incur the full costs of these additional expenditures while the expansionary effect spreads throughout the entire country. Hence the municipalities face virtually no incentives to fight recessions³³. A similar course of argumentation can be applied to illustrate that municipalities have no incentives to restrict their expenditures in times of a boom either. Thus municipalities cannot be expected to engage in economic stabilisation policies. In Germany, where the municipalities are very restricted in their possibilities to incur debts, even pro-cyclical behavior can be observed.

Second, local environmental policies usually exert positive externalities on the quality of living in the neighbouring municipalities. As environmental policies cause direct as well as indirect costs in the short-run perspective, the municipalities will – under a regime of municipal autonomy in environmental policies – underinvest in the preservation of the environment. The competition between municipalities set further limits to local environmental policies. This is due to the fact, that high environmental standards impose additional costs on the local enterprises. Rational firms thus try to concentrate their production in municipalities with low environmental standards. Thus the municipal competition for mobile capital causes the municipal administration to neglect its obligations in the field of environmental policy. Though a dramatic race-to the bottom is not supported by the empirical literature, municipalities can be expected to engage in an inefficiently low level of environmental protection³⁴.

3.2.4. Distortions of resource allocation

In their competition, the municipalities are especially interested in attracting firms to invest in their district. These create jobs and increase the municipal revenues. As capital is generally assumed to be more mobile than labor, especially the competition for investments is very heavy. Hence the municipalities have incentives to primarily supply services and infra-

³² E.g. W. E. Oates, *Fiscal Federalism...*, p. 8.

³³ *Ibidem*, p. 4–6.

³⁴ W. E. Oates, *An Essay on...*, p. 1134–1137.

structure which suits the needs of firms rather than the local population³⁵. In addition, they may try to attract firms by setting especially weak environmental standards and standards concerning health and safety at work³⁶.

Many authors have argued that through this mechanism, the competition between municipalities will lead to a race to the bottom in corporate taxes and environmental standards. Empirical investigations do, however, suggest that the mobility of capital is restricted³⁷. Nevertheless the competition for scarce capital between municipalities can be expected to lead to low corporate taxes, an inefficient structure of public goods and services for the private households and low environmental standards and standards concerning health and safety at work.

3.2.5. Strict limitations to distributional policy

The process of competition for mobile capital explained in the previous sections limits the contribution of corporate taxes to financing public expenditures. Instead, the local authorities have to rely more heavily on taxes collected from immobile factors and residents³⁸. Thus private households are taxed more heavily than they would have been in a more centralized state. In addition, those households who receive a high income benefit to a larger extent from the lower corporate taxes than low-income households. Thus competition between municipalities makes the income distribution more unequal³⁹.

At the same time, every municipality can be expected to offer as few social transfers as possible. This saves expenditures directly and indirectly by setting incentives for potential recipients of such transfers to migrate to other municipalities which offer higher transfers. Simultaneously, any municipality can try to attract individuals with a high income by offering low income taxes. As a consequence, municipalities which offer high transfer payments and finance these through high taxes will be subject to

³⁵ E.g. M. Keen, M. Marchand, *Fiscal Competition and the Pattern of Public Spending*, „Journal of Public Economics” 1997, 66, p. 33–53.

³⁶ W. E. Oates, *An Essay on...*, p. 1134–1137; T. Apolte, *Die ökonomische Konstitution eines föderalen Systems: dezentrale Wirtschaftspolitik zwischen Kooperation und institutionellem Wettbewerb*, Tübingen 1999, Mohr Siebeck, p. 125–127.

³⁷ E.g. G. Kirchgaessner, W. W. Pommerehne, *Tax harmonization and tax competition in the European Union: Lesson from Switzerland*, „Journal of Public Economics” 1996, Vol. 60, p. 351–371; T. Apolte, *op. cit.*, p. 125–127, 161–163.

³⁸ S. Bucotevsky, J. D. Wilson, *Tax Competition with Two Tax Instruments*, „Regional Science and Urban Economics” 1991, 21, p. 333–350.

³⁹ O. Lorz, *Capital Mobility, Tax Competition, and Lobbying for Redistributive Capital Taxation*, „Kiel Working Paper” 1996, No. 779.

emigration of high-income individuals and a simultaneous influx of potential recipients of welfare payments. In the long run, these municipalities are threatened by bankruptcy. To prevent bankruptcy, they will react by lowering both income taxes for mobile residents and transfer payments. Thus the municipal autonomy in setting major taxes and social transfer payments leads to a massive reduction in taxes on mobile households but also in social transfers⁴⁰. In general, high-income residents can be expected to be more mobile than low-income residents. Consequently, the described competition between municipalities forces these to restrict taxes on mobile high-income households as well as transfer payments. Following this course of argumentation, the competition between municipalities is found to limit the possibilities for distributive policies on the local level⁴¹. The empirical evidence on this issue is mixed. Kirchgaessner and Pommerehne (1996) show in an empirical investigation that this conclusion is based on the assumption of an unrealistically high level of household mobility. They have analysed income tax burdens in different regions in Switzerland and found quite substantial differences in effective tax burdens but very little migration between regions of different tax-burdens. Feld and Kirchgaessner on the other hand found evidence for intensive tax competition between Swiss cantons. Nevertheless interregional differences in tax rates are not observed to disappear entirely. These results suggest that – within limits – distributional policies can partly be conducted on local level.

4. TASKS OF THE CENTRAL GOVERNMENT IN A FEDERALIST STATE WITH STRONG MUNICIPAL AUTONOMY

As the illustrations in section 3 show, far-reaching municipal autonomy in tasks and revenues can help to achieve an efficient provision of public goods and services. At the same time, it can cause a number of problems especially in the field of stabilization and distribution policy. An ideal institutional framework must thus make use of the advantages of municipal autonomy and simultaneously restrict it with respect to the problems stated in section 3.2. In this framework, the municipalities have some autonomy in tasks and revenues, while some tasks and revenues are decided upon on the central level. This section outlines the general tasks of the central government in a federalist state with strong municipal autonomy. Four major fields of central government interventions can be identified: coordination

⁴⁰ W. E. Oates, *Fiscal Federalism...*, p. 6-8; D. L. Rubinfeld, *op. cit.*, p. 627; R. Boadway, *op. cit.*, p. 105-107.

⁴¹ E.g. K. Boadway, *op. cit.*, p. 100.

of the provision of public goods and services on the local level, economic stabilisation, distributional policies and policies to guarantee the workability of competition between municipalities.

4.1. Coordination of the provision of public goods and services on the local level

Today, the public sector in most countries provides a large variety of different public goods and services. As outlined in section 3, the characteristics of a certain good or service determine which administrative body can best provide a certain good or service. Whenever it can be provided in small units and is not characterized by economies of scale or spill-overs, the municipalities should have the full autonomy of task in this field. Public parks or playgrounds belong to this category of goods. If, however, goods and services are characterized by economies of scale, one production plant should supply more than one municipality to produce at minimum costs. Hospitals as well as local water and electricity supply are typical examples for such tasks. Three solutions can be applied to guarantee the optimal supply of these services. First, the economies of scale can be exploited if only a few municipalities run plants to produce the corresponding goods while the others buy the services of them⁴². Second, the municipalities can enter negotiations to run the plants jointly e.g. by founding a joint venture. These two solutions leave the relevant autonomy in tasks with the municipalities. According to the third solution, the autonomy to decide about the provision of such goods is transferred to regional or even national authorities. Following the principle of subsidiarity, the second (third) solution must only be applied if the first (second) one proves unsuitable⁴³. In the majority of cases of economies of scale, the reduction of municipal autonomy has not been necessary in practice. The central government may, however, install a risk-sharing mechanism between the municipalities if the first solution is applied. In case of the second solution, the central government can coordinate and supervise the supra-municipal negotiations.

In those cases where spill-overs occur, such negotiations are usually not sufficient to internalise the spill-over and guarantee an efficient supply of the corresponding goods and services. This is due to the fact that each municipality faces strong incentives to act strategically in these negotiations.

⁴² K. Bulutoglu, *op. cit.*, p. 9–10.

⁴³ E.g. K. Homann, C. Kirchner, *Das Subsidiaritätsprinzip in der Katholischen Soziallehre und in der Ökonomik*, [in:] L. Gerken (ed.), *Europa zwischen Ordnungswettbewerb und Harmonisierung*, Springer, Berlin 1995, p. 45–69.

In addition, the negotiations are often very lengthy and complicated and thus cause substantial transaction costs. Environmental policies pose an excellent example for a field of policy where negotiations between subordinate authorities do not lead to satisfactory results. Consequently, the autonomy in task should be centralized when spill-overs occur. As increasing the size of the administrative body in charge reduces spill-overs, regional or national authorities are more likely to supply the optimal amount of the public goods and services at hand⁴⁴. In many cases, it suffices to make the decisions as such on the central level, while the municipalities – monitored by the central government – are in charge of putting them through⁴⁵. Thereby the spill-overs can be internalised and at the same time it is possible to harvest the benefits of local provision of public goods and services.

4.2. Macroeconomic stabilisation policy

As illustrated in section 3.2.4, municipalities face little incentives to pursue a policy of stabilization. Thus the central government has to be in charge of the policy of macroeconomic stabilization. At the same time, the central government can only fulfil this task efficiently if its efforts are supported by the municipalities. Therefore these must be granted a steady flow of revenues throughout the entire business cycle. This can partly be achieved by giving them the autonomy in revenues on those taxes which do not fluctuate in the course of the business cycle (e.g. property taxes). In order to cover extra-expenditures in times of recession and prevent excessive expenditures in times of a boom, the vertical transfers must be higher in times of recession and lower in times of booms⁴⁶.

4.3. Distributional policy

As illustrated in section 3, municipalities are very restricted in their possibilities to influence the size or regional distribution of income through taxes and transfer payments. A voluntary coordination of municipalities to coordinate distributional policies is difficult to reach due to high transaction costs and opportunistic behavior. In order to reduce interregional inequality, resources must be transferred from one municipality or region to another without an equivalent return. Autonomous municipalities cannot be expected

⁴⁴ E.g. W. E. Oates, *op. cit.*, p. 1134–1137.

⁴⁵ E.g. R. Boadway, *op. cit.*, p. 101.

⁴⁶ E.g. D. L. Rubinfeld, *op. cit.*, p. 626–627.

to agree on substantial horizontal transfer payments⁴⁷. Thus distributional policies require interventions by the central government⁴⁸. Two different solutions can be applied:

First, the central government can restrict the autonomy in all tasks and revenues which significantly influence the distribution of income. This can be achieved by setting minimum standards for social transfers which are binding for all municipalities. These minimum standards have to be supplemented by minimum tax rates especially on the income of mobile residents and maximum tax rates for those taxes paid by more immobile inhabitants. If setting standards is not sufficient to influence the income distribution to the planned extent, the central government can capture the full autonomy in tasks and revenues in all necessary fields. Under this second solution, the central administrative body dictates the tax base and the exact tax rate for all important taxes. In the field of social transfers, the level of transfers as well as the characteristics of the entitled beneficiaries are prescribed in detail. The municipalities are only in charge of collecting the taxes and distributing the social transfers.

In Germany, a mixture of both methods is applied. In the field of public assistance, the central authorities have only set minimum standards that the municipalities have to meet (see section 2). This solution can help to distribute the resources less unerringly because the local authorities can account for differences in the costs of living⁴⁹. At the same time, all major taxes are decided upon on the central level. These include the income tax, turnover tax and corporate tax. The municipalities are not even allowed to tax the same tax base in local taxes⁵⁰.

Apart from the size distribution of income, many countries also pursue a policy of lowering regional disparities in income and economic power. While such policies only play a subordinate role in the US, substantial resources are transferred between different German administrative bodies in order to influence the regional distribution of income. The initial inter-municipal differences in publicly provided goods and services, especially

⁴⁷ E.g. R. Boadway, *op. cit.*, p. 105–107.

⁴⁸ E.g. W. E. Oates, *op. cit.*, p. 6–8.

⁴⁹ E.g. H. F. Ladd, F. C. Dootlitttle, *Which Level of Government Should Assist the poor?*, „National Tax Journal“ 1982, 35 (3), p. 323–336, reprinted in: W. E. Oates (ed.), *The economics of...*, p. 388–401.

⁵⁰ Not all countries have installed such strict rules on the division of tax bases (e.g. B. Seidel, D. Vesper, *op. cit.*, p. 451). The absence of such a strict division does, however, lead to vertical externalities (e.g. E. Heylen, *Tax Autonomy and the Financing of Second – Level Governments: a Comparative Study*, [in:] P. Friedrich, P. van Rompuy (eds.), *Fiscal Decentralization*, Nomos, Baden-Baden 1987; R. Boadway, *op. cit.*, p. 107–108). These pose a problem for the central government's ability to pursue a policy of macroeconomic stabilization.

in infrastructure largely result from differences in per-capita production and income and thus in the ability to raise own revenues. The interregional redistribution policy of income aims at reducing these differences until all municipalities provide at least a politically defined minimum standard. For this purpose, the poorer municipalities receive more vertical transfers per capita from central and regional authorities than rich municipalities⁵¹. In addition, some German Bundesländer have installed a system of horizontal transfers which redirects resources from rich municipalities to poorer ones.

4.4 Ensuring a workable competition between municipalities

Following the logic put forth in sections 4.2 and 4.3 the municipal autonomy in tasks and revenues has been restricted in most countries. As a side-effect, however, the intensity of competition between municipalities is reduced substantially. This in turn reduced the incentives for municipalities to offer a bundle of public goods and services which suits the preferences of the local population and to produce these goods and services at minimum costs in order to foster regional economic growth. Consequently, the incentives for poor municipalities to try to induce growth to catch up to the rich municipalities are very low. Consequently, economic growth rates may be lower than they could be and differences in average income between municipalities may be cemented. These negative aspects of reducing the municipal autonomy are pointed out more and more strongly in the recent scientific discussion on the pros and cons of municipal autonomy⁵². This discussion has also influenced the political debate on the reform of the new system of vertical and horizontal transfers between different municipalities and regions in Germany⁵³.

Centralist tendencies are, however, not the only driving force that reduces the intensity of competition between municipalities. Instead, the municipalities themselves have incentives to restrict this competition⁵⁴. This

⁵¹ E.g. M. Schlie, *Finanzausgleich in Deutschland: Struktur, finanzielle Auswirkung und Reformvorschläge*, „Die Weltwirtschaft“ 1999, (2), p. 188–206; H. G. Napp, *Kommunale Finanzautonomie und ihre Bedeutung für eine effiziente lokale Finanzwirtschaft*, Peter Lang, Frankfurt am Main 1994, p. 267–299.

⁵² E.g. D. L. Rubinfeld, *op. cit.*, p. 628–629; H. G. Napp, *Kommunale Finanzautonomie und ihre Bedeutung für eine effiziente lokale Finanzwirtschaft*, Peter Lang, Frankfurt am Main 1994, p. 294–298.

⁵³ E.g. M. Schlie, *Finanzausgleich in Deutschland: Struktur, finanzielle Auswirkung und Reformvorschläge*, „Die Weltwirtschaft“ 1999, Nr. 2, p. 188–206; H. Zimmermann, *op. cit.*

⁵⁴ E.g. S. Sinn, *The Taming of the Leviathan: Competition among Governments*, „Constitutional Political Economy“ 1992, 3, p. 188–190; B. S. Frey, R. Eichenberger, *op. cit.*, p. 10.

can, for instance, be achieved by discriminating firms from other municipalities or supporting local firms with unjustified subsidies. The municipalities can additionally try to install barriers that hinder the population to migrate from one municipality to another. In particular, the municipalities can try to prevent the emigration of high-income households and reduce the influx of potential recipients of social transfers. All tendencies to restrict the competition between municipalities must be stepped up to by the central government. In this context, a "Wettbewerbsordnung" for the competition among governments should be installed⁵⁵. It has to secure the competition through general legislation as well as through active control and interventions. Otherwise municipal competition cannot exert its positive impact illustrated in section 2. Especially the renunciation of the knowledge-creating properties of competition will cause massive opportunity costs in the long-run perspective.

5. CONCLUSION

The passages above have outlined the pros and cons of far-reaching municipal autonomy. In addition, the role of the central administrative body in a federal state have been briefly discussed. The limited time and space made it necessary to concentrate on some key issues. First of all the illustrations showed that there is no simple one-sentence answer to the question to which extent municipalities should be granted autonomy in tasks and revenues. There are strong points in favor of far-reaching decentralization in the field of providing public goods and services, especially infrastructure, unless economies of scale or spill-overs occur. The policy of economic stabilization as well as distributional policies must, however, be carried out by the central government. Therefore the municipal autonomy in task must be restricted when it comes to social welfare payments. The municipalities are furthermore given no influence on the tax base or tax rate of all major taxes. Consequently the municipalities' autonomy in revenues is extremely small. The resulting financial restrictions also reduce the autonomy in tasks. In the end, the municipal autonomy has been cut down drastically, leaving only little room for competition between municipalities. As a result, the incentives for cost-efficiency and demand-orientation on the municipal level are limited.

⁵⁵ E.g. H. Siebert, M. Koop, *op. cit.*, p. 445-446; V. Vanberg, W. Kerber, *Institutional Competition among Jurisdiction*, „Constitutional Political Economy" 1994, 5, p. 212-216.

*Ivo Bischoff, Armin Bohnet***SAMODZIELNOŚĆ JEDNOSTEK SAMORZĄDU TERYTORIALNEGO
W PAŃSTWIE FEDERALNYM**

W większości państw władza administracyjna nie jest skoncentrowana wyłącznie na szczeblu centralnym, lecz jest rozdzielona pomiędzy władzę na szczeblu krajowym, regionalnym i lokalnym. Jednocześnie stopień samodzielności władz lokalnych i regionalnych różni się w poszczególnych państwach.

Na samodzielność tę składa się zarówno autonomia w podejmowaniu i wypełnianiu zadań, jak i swoboda w pozyskiwaniu dochodów i dysponowaniu nimi. Istnieje wiele przesłanek przemawiających na korzyść daleko idącej decentralizacji, takich jak np. lepsze dostosowanie publicznych dóbr i usług do potrzeb społeczności lokalnych, niższe koszty administracyjne, zwiększenie innowacyjności w sektorze publicznym. Z drugiej jednak strony wysoki stopień samodzielności jednostek samorządu terytorialnego wiąże się m. in. z kosztami utrzymania wybieranych władz samorządowych czy niemożnością wykorzystania w pełnym stopniu ekonomii skali.

Celem artykułu jest wskazanie wad i zalet daleko idącej samodzielności jednostek samorządu terytorialnego i odpowiedź na pytanie, do jakiego stopnia i w jakim zakresie samodzielność powinna być przyznana tym jednostkom.